

ESSAY: RESTRUCTURING CORPORATE DEBT IN THE CONTEXT OF A SYSTEMIC CRISIS

SEAN HAGAN*

I

INTRODUCTION

If one reviews the debt problems facing the membership of the International Monetary Fund (IMF) today—particularly in Central and Eastern Europe—it is relatively clear that the most immediate challenges relate to the restructuring of nonsovereign debt. For this reason, the focus of this brief contribution will be on the difficulty of designing and implementing debt restructuring frameworks in the nonsovereign and, in particular, the corporate context. Of course, these issues possess a sovereign dimension in at least two respects. First, it is clear that the debt crisis faced by many of our members is systemic in nature and accordingly, will require some degree of intervention by the government—even if the debt is held on the balance sheet of the corporate sector. Second, to the extent that government intervention involves financial assistance, such assistance may raise issues regarding the sustainability of the government’s own indebtedness.

An understanding of the IMF’s perspective of these issues requires a brief overview of the nature of our involvement. The IMF provides financial assistance to its members in order to assist them in addressing their balance of payments problems. Before it does so, however, it must make a determination that two conditions have been met. First, since its resources are to be used to help countries resolve their balance of payments problems, it is important that the country be implementing policies that will address—rather than simply delay the resolution of—its balance of payments problems. Second, the IMF must ensure that “adequate safeguards” are in place to ensure that the member will be in a position to repay the IMF within the relatively short timeframe mandated under the IMF’s Articles of Agreement, generally three to five years.

“Conditionality” refers to the mechanism whereby IMF financial assistance is made conditional upon the effective implementation of a credible adjustment program, thereby ensuring, in turn, that the above conditions are in place. The

adoption of appropriate adjustment policies is designed not only to give the IMF some assurance that the underlying cause of the member's balance of payments problems will be corrected, but also to provide the IMF with an adequate basis to conclude that the member will have sufficient financial recourse to repay the IMF once the adjustment program has been successfully implemented.

It should be emphasized that the amount of financing provided by the IMF has traditionally been relatively modest in comparison with a member's needs. However, the IMF's judgment that the member's adjustment program merits financial support is intended to "catalyze" financial assistance from other sources and, in the medium term, facilitate return to capital markets.

II

THE IMF'S APPROACH TO CENTRAL AND EASTERN EUROPE—COMPARISON TO THE ASIAN CRISIS

In response to the recent financial crisis, the IMF has been providing financial assistance in support of adjustment efforts to a number of countries in Central and Eastern Europe. In looking at both the nature of their problems and their adjustment programs, there are clear similarities with the countries we assisted during the Asian crisis. In terms of the underlying balance of payments problems, in Central and Eastern Europe, a number of countries had experienced explosive growth that had been fueled by foreign borrowing. This borrowing had been facilitated by a fixed exchange rate that made loans both easier to secure and easier to service. Unfortunately, this growth created enormous and unsustainable increases in asset prices, including in the housing sector. This resulted, in turn, in a lack of confidence among foreign creditors in the sustainability of policies—including exchange rate policies. As in the case of Asia, this lack of confidence resulted in capital outflows and, because the authorities did not have adequate resources to meet these outflows, the exchange rate suffered a large depreciation. Importantly, since much of the borrowing incurred by the banking, corporate, and household sector had been denominated in foreign exchange, this borrowing resulted in the overindebtedness of large portions of the banking and corporate sector.

As with the IMF-supported programs in Asia, a key element of the IMF's assistance in several of these countries has involved supporting a more realistic exchange rate policy that would, among other things, boost competitiveness. As a result of the dislocation in the balance sheets of the banks, corporations, and households caused by the depreciation, the programs have also focused on a comprehensive debt restructuring strategy.

Notwithstanding the similarities with the Asian crisis, however, there are important differences.

First, the problems in Asia were triggered exclusively by a loss of confidence in the policies of those countries. In Central and Eastern Europe, the outflows have also been exacerbated by the deleveraging process that occurred at a

global level due to the problems experienced in a number of developed countries, such as the United States and the United Kingdom.

Second, during the Asian crisis, the stabilization program was achieved through a combination of external financing from the IMF (and other official creditors) and economic adjustment. Although there had been widespread insolvency in the banking and corporate sectors, there was no need to rely on exchange controls. In Central and Eastern Europe, however, this has not always been the case. Most notably, in Iceland, the authorities have had little choice but to rely on comprehensive exchange controls to staunch capital outflows and thereby ensure the effectiveness of the stabilization programs. While these controls were in place before the IMF approved the relevant stand-by arrangement, the IMF recognized that, at least in the short term, these controls were necessary given that the amount of external financing being provided, even when coupled with the economic adjustment being implemented, was outstripped by the level of capital outflows.

A key issue facing the countries in Central and Eastern Europe that have been affected by the crisis relates to the design and implementation of a corporate restructuring strategy. As in the case of the Asian crisis, the overindebtedness of a large portion of the corporate sector has been triggered not only by exchange rate depreciation but also by the collapse in availability of credit arising from the insolvency of large portions of the banking sector. Moreover, as in the Asian crisis, it is recognized that the restructuring of corporate debt owed to nonresidents is necessary in order to regain access to capital markets. More generally, of course, reducing the debt burden of the corporations is a necessary condition for achieving greater employment and economic growth.

III

LESSONS FROM THE ASIAN CRISIS

Accordingly, when contemplating the difficulties that are currently being confronted in Central and Eastern Europe, it is natural to reflect upon lessons that can be learned from the corporate restructuring that took place during the Asian crisis. During the Asian crisis, government intervention supported the restructuring process in three areas. First, the government established a legal and institutional framework that would support the rehabilitation and liquidation of enterprises, primarily through the adoption of insolvency laws and the strengthening of the judicial system. Second, and relatedly, the government established out-of-court frameworks that facilitated such restructurings, albeit in the shadow of the formal insolvency system. Finally, to the extent to which the sovereign became a creditor to the corporate sector by virtue of its acquisition of liabilities through the bank restructuring process, it also played a leading role in the negotiation strategy—often, through the leverage gained by stronger legal enforcement powers that had been conferred upon it in the enabling legislation. At the time, the prevailing view was that, as a

matter of principle, public funds should not be used to support corporate restructuring. There was a concern that such intervention would engender moral hazard: by shielding both creditors and corporate debtors from their losses, this intervention would only encourage risky behavior going forward. Although public funds were used to support the restructuring of the banking sector, the provision of these funds was considered an appropriate step given both the systemic implications of the collapse of the banking sector and the preexisting public exposure arising from the deposit guarantee system.

IV

WHY MORE GOVERNMENT INTERVENTION MAY BE NECESSARY

Looking at the challenges currently faced by the IMF's members regarding the overindebtedness of their corporate sectors, there are several reasons why a more robust role for the government may be necessary going forward. At the outset, one needs to acknowledge that recent events have demonstrated that moral hazard concerns have been superseded by others. The level and depth of government intervention in industrial countries, including financial intervention, has been unprecedented. As evidenced by the U.S. intervention in the automobile industry, this intervention has been extended to the corporate sector. It is difficult to continue to apply the principle of moral hazard rigidly in emerging markets when it is being applied rather more flexibly elsewhere.

Moreover, one of the lessons of the Asian crisis is that it is important to manage expectations as to how quickly insolvency reform can be implemented. As a legal matter, amendments to an insolvency law cannot be introduced in isolation; they often require legislative modifications in other areas, including contract enforcement and civil procedure. In addition, meaningful reform involves more than just the adoption of legislation. Perhaps more than any other legal framework, an effective insolvency system requires a competent institutional infrastructure composed not only of the judiciary, but also of professional trustees. As the experience of Asia demonstrates, an insolvency law is as weak as the weakest institution that is charged with implementing it. In addition, the implementation of an insolvency law during a crisis is complicated by the pressure that vested interests often bring to bear. Since the introduction of new laws or the amendments to these laws apply to existing debt, introducing new rules to address an outstanding debt overhang makes the legislative process a politically charged one. Finally, during a crisis, even the most effective insolvency system may be overcome by the number of cases presented. While an out-of-court framework can assist in this respect, many successful cases will need to be processed through the formal system in order to take advantage of the cram-down provisions of the law (that is, the use of pre-packaged or "fast-track" bankruptcy).

Even if government is successful in putting in place a corporate debt restructuring framework through the establishment of both a formal and out-of-court system, the question remains as to whether it will actually be used.

Although an effective system should give creditors the legal leverage they need to bring debtors to the table, experience demonstrates that many creditors will prefer to bide their time until the economy recovers sufficiently to strengthen the debt servicing capacity of the debtor. Of course, if all creditors take this position, the overall restructuring process will be delayed, thereby undermining the recovery. The problem may be viewed as a form of market failure and is exacerbated by the fact that in many of these countries, there is very little experience with corporate debt restructuring.

Given the above, it is relatively clear that the government may need to provide additional incentives beyond an insolvency framework in order to catalyze the restructuring process. Whether these incentives are financial or regulatory in nature will depend on the situation of the country in question. For example, in some cases, it may be possible for the government to provide financing incentives in the form of guarantees on the restructured claims. However, the viability of this approach will depend on the amount of fiscal space available to the government. In some Central and Eastern European countries, this problem is complicated by the fact that there is also pressure on the sovereign to support the restructuring of consumer debt. For example, a good portion of the mortgages in Hungary and the Ukraine were denominated in foreign exchange and accordingly, the subsequent depreciation has had a devastating impact on the balance sheets of that sector. Not surprisingly, there has been considerable pressure on the government to provide some form of financial support in this area. It should be noted that this problem was not present during the Asian crisis.

When contemplating the design and implementation of a corporate restructuring strategy in the context of a systemic crisis, it is necessary to consider not only the instruments that will be the most effective, but also the sequencing of the strategy. In particular, it is unreasonable to expect that there will be a restructuring of corporate sector debt before macroeconomic stabilization has been achieved. While values and prices are uncertain, creditors and debtors are unlikely to be in a position to conclude agreements. Moreover, one of the other lessons from the Asian crisis is that one needs a minimum level of stability in the banking sector before a corporate restructuring strategy can be implemented. Such stability may require significant recapitalization. Unless banks are in a financial position to write down the value of their loans, they will not be in a position to agree to the level of debt reduction that will be necessary to ensure the viability of the corporation in question.

V

CONCLUSION

In light of the complexity of the issues identified above, it may be tempting to seek simpler and faster solutions. Unfortunately, the IMF has not been able to identify them. Across-the-board restructurings achieved through government fiat that do not involve enterprise-by-enterprise analysis and negotiations

among creditors and debtors can do lasting damage to the investment climate of the country concerned. While a lesson from the Asian crisis is that the government needs to be proactively involved in establishing incentives for the rapid and orderly restructuring process, it should not substitute itself for the parties concerned.